

COMMERCIAL BANKING

INTRODUCTION

Banking occupies one of the most important positions in the modern economic world. It is necessary for trade and industry. Hence it is one of the great agencies of commerce. Although banking in one form or another has been in existence from very early times, modern banking is of recent origin. It is one of the results of the Industrial Revolution and the child of economic necessity. Its presence is very helpful to the economic activity and industrial progress of a country.

Meaning

A commercial bank is a profit-seeking business firm, dealing in money and credit. It is a financial institution dealing in money in the sense that it accepts deposits of money from the public to keep them in its custody for safety. So also, it deals in credit, i.e., it creates credit by making advances out of the funds received as deposits to needy people. It thus, functions as a mobiliser of saving in the economy. A bank is, therefore like a reservoir into which flow the savings, the idle surplus money of households and from which loans are given on interest to businessmen and others who need them for investment or productive uses.

Definition of a Bank

The term 'Bank' has been defined in different ways by different economists. A few definitions are:

According to Walter Leaf "A bank is a person or corporation which holds itself out to receive from the public, deposits payable on demand by cheque." Horace White has defined a bank, "as a manufacture of credit and a machine for facilitating exchange."

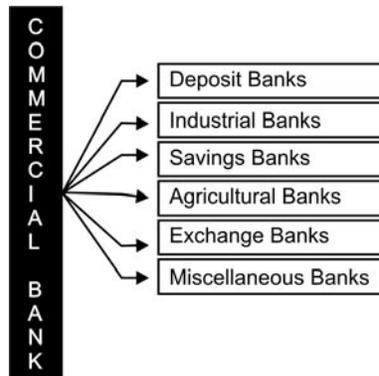
According to Prof. Kinley, "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use."

The Banking Companies Act of India defines Bank as “A Bank is a financial institution which accepts money from the public for the purpose of lending or investment repayable on demand or otherwise withdrawable by cheques, drafts or order or otherwise.”

Thus, we can say that a bank is a financial institution which deals in debts and credits. It accepts deposits, lends money and also creates money. It bridges the gap between the savers and borrowers. Banks are not merely traders in money but also in an important sense manufacturers of money.

TYPES OF BANKS

Broadly speaking, banks can be classified into commercial banks and central bank. Commercial banks are those which provide banking services for profit. The central bank has the function of controlling commercial banks and various other economic activities. There are many types of commercial banks such as deposit banks, industrial banks, savings banks, agricultural banks, exchange banks, and miscellaneous banks.



Types of Commercial Banks

1. **Deposit Banks:** The most important type of deposit banks is the commercial banks. They have connection with the commercial class of people. These banks accept deposits from the public and lend them to needy parties. Since their deposits are for short period only, these banks extend loans only for a short period. Ordinarily these banks lend money for a period between 3 to 6 months. They do not like to lend money for long periods or to invest their funds in any way in long term securities.
2. **Industrial Banks:** Industries require a huge capital for a long period to buy machinery and equipment. Industrial banks help such industrialists. They provide long term loans to industries. Besides, they buy shares and debentures of companies, and enable them to have fixed capital. Sometimes, they even underwrite the debentures and shares of big industrial concerns. The important functions of industrial banks are:

1. They accept long term deposits.
2. They meet the credit requirements of industries by extending long term loans.
3. These banks advise the industrial firms regarding the sale and purchase of shares and debentures.

The industrial banks play a vital role in accelerating industrial development. In India, after attainment of independence, several industrial banks were started with large paid up capital. They are, The Industrial Finance Corporation (I.F.C.), The State Financial Corporations (S.F.C.), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI) etc.

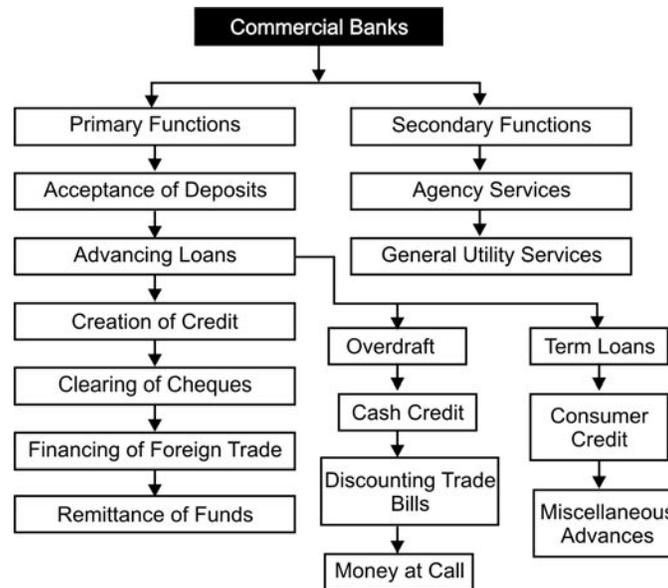
3. **Savings Banks:** These banks were specially established to encourage thrift among small savers and therefore, they were willing to accept small sums as deposits. They encourage savings of the poor and middle class people. In India we do not have such special institutions, but post offices perform such functions. After nationalisation most of the nationalised banks accept the saving deposits.
4. **Agricultural Banks:** Agriculture has its own problems and hence there are separate banks to finance it. These banks are organised on co-operative lines and therefore do not work on the principle of maximum profit for the shareholders. These banks meet the credit requirements of the farmers through term loans, viz., short, medium and long term loans. There are two types of agricultural banks,
 - (a) Agricultural Co-operative Banks, and
 - (b) Land Mortgage Banks. Co-operative Banks are mainly for short periods. For long periods there are Land Mortgage Banks. Both these types of banks are performing useful functions in India.
5. **Exchange Banks:** These banks finance mostly for the foreign trade of a country. Their main function is to discount, accept and collect foreign bills of exchange. They buy and sell foreign currency and thus help businessmen in their transactions. They also carry on the ordinary banking business.

In India, there are some commercial banks which are branches of foreign banks. These banks facilitate for the conversion of Indian currency into foreign currency to make payments to foreign exporters. They purchase bills from exporters and sell their proceeds to importers. They purchase and sell “forward exchange” too and thus minimise the difference in exchange rates between different periods, and also protect merchants from losses arising out of exchange fluctuations by bearing the risk. The industrial and commercial development of a country depends these days, largely upon the efficiency of these institutions.

6. **Miscellaneous Banks:** There are certain kinds of banks which have arisen in due course to meet the specialised needs of the people. In England and America, there are investment banks whose object is to control the distribution of capital into several uses. American Trade Unions have got labour banks, where the savings of the labourers are pooled together. In London, there are the London Discount House whose business is “to go about the city seeking for bills to discount.” There are numerous types of different banks in the world, carrying on one or the other banking business.

FUNCTIONS OF COMMERCIAL BANKS

Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as 'General Banking' functions of the commercial banks. The modern banks perform a variety of functions. These can be broadly divided into two categories: (a) Primary functions and (b) Secondary functions.



A. Primary Functions

Primary banking functions of the commercial banks include:

1. Acceptance of deposits
2. Advancing loans
3. Creation of credit
4. Clearing of cheques
5. Financing foreign trade
6. Remittance of funds

1. **Acceptance of Deposits:** Accepting deposits is the primary function of a commercial bank mobilise savings of the household sector. Banks generally accept three types of deposits viz., (a) Current Deposits (b) Savings Deposits, and (c) Fixed Deposits.

- (a) *Current Deposits:* These deposits are also known as demand deposits. These deposits can be withdrawn at any time. Generally, no interest is allowed on current deposits, and in case, the customer is required to leave a minimum balance undrawn with the bank. Cheques are used to withdraw the amount. These deposits are kept by businessmen and industrialists who receive and make

large payments through banks. The bank levies certain incidental charges on the customer for the services rendered by it.

- (b) *Savings Deposits:* This is meant mainly for professional men and middle class people to help them deposit their small savings. It can be opened without any introduction. Money can be deposited at any time but the maximum cannot go beyond a certain limit. There is a restriction on the amount that can be withdrawn at a particular time or during a week. If the customer wishes to withdraw more than the specified amount at any one time, he has to give prior notice. Interest is allowed on the credit balance of this account. The rate of interest is greater than the rate of interest on the current deposits and less than that on fixed deposit. This system greatly encourages the habit of thrift or savings.
- (c) *Fixed Deposits:* These deposits are also known as time deposits. These deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice for withdrawal. If the depositor is in need of money, he has to borrow on the security of this account and pay a slightly higher rate of interest to the bank. They are attracted by the payment of interest which is usually higher for longer period. Fixed deposits are liked by depositors both for their safety and as well as for their interest. In India, they are accepted between three months and ten years.

2. **Advancing Loans:** The second primary function of a commercial bank is to make loans and advances to all types of persons, particularly to businessmen and entrepreneurs. Loans are made against personal security, gold and silver, stocks of goods and other assets. The most common way of lending is by:

- (a) *Overdraft Facilities:* In this case, the depositor in a current account is allowed to draw over and above his account up to a previously agreed limit. Suppose a businessman has only Rs. 30,000/- in his current account in a bank but requires Rs. 60,000/- to meet his expenses. He may approach his bank and borrow the additional amount of Rs. 30,000/-. The bank allows the customer to overdraw his account through cheques. The bank, however, charges interest only on the amount overdrawn from the account. This type of loan is very popular with the Indian businessmen.
- (b) *Cash Credit:* Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time, instead the amount is credited into his account in the bank; but under emergency cash will be given. The borrower is required to pay interest only on the amount of credit availed to him. He will be allowed to withdraw small sums of money according to his requirements through cheques, but he cannot exceed the credit limit allowed to him. Besides, the bank can also give specified loan to a person, for a firm against some collateral security. The bank can recall such loans at its option.
- (c) *Discounting Bills of Exchange:* This is another type of lending which is very popular with the modern banks. The holder of a bill can get it discounted by the bank, when he is in need of money. After deducting its commission, the bank

pays the present price of the bill to the holder. Such bills form good investment for a bank. They provide a very liquid asset which can be quickly turned into cash. The commercial banks can rediscount, the discounted bills with the central banks when they are in need of money. These bills are safe and secured bills. When the bill matures the bank can secure its payment from the party which had accepted the bill.

- (d) *Money at Call:* Bank also grant loans for a very short period, generally not exceeding 7 days to the borrowers, usually dealers or brokers in stock exchange markets against collateral securities like stock or equity shares, debentures, etc., offered by them. Such advances are repayable immediately at short notice hence, they are described as money at call or call money.
 - (e) *Term Loans:* Banks give term loans to traders, industrialists and now to agriculturists also against some collateral securities. Term loans are so-called because their maturity period varies between 1 to 10 years. Term loans, as such provide intermediate or working capital funds to the borrowers. Sometimes, two or more banks may jointly provide large term loans to the borrower against a common security. Such loans are called participation loans or consortium finance.
 - (f) *Consumer Credit:* Banks also grant credit to households in a limited amount to buy some durable consumer goods such as television sets, refrigerators, etc., or to meet some personal needs like payment of hospital bills etc. Such consumer credit is made in a lump sum and is repayable in instalments in a short time. Under the 20-point programme, the scope of consumer credit has been extended to cover expenses on marriage, funeral etc., as well.
 - (g) *Miscellaneous Advances:* Among other forms of bank advances there are packing credits given to exporters for a short duration, export bills purchased/discounted, import finance-advances against import bills, finance to the self employed, credit to the public sector, credit to the cooperative sector and above all, credit to the weaker sections of the community at concessional rates.
3. **Creation of Credit:** A unique function of the bank is to create credit. Banks supply money to traders and manufacturers. They also create or manufacture money. Bank deposits are regarded as money. They are as good as cash. The reason is they can be used for the purchase of goods and services and also in payment of debts. When a bank grants a loan to its customer, it does not pay cash. It simply credits the account of the borrower. He can withdraw the amount whenever he wants by a cheque. In this case, bank has created a deposit without receiving cash. That is, banks are said to have created credit. Sayers says “banks are not merely purveyors of money, but also in an important sense, manufacturers of money.”
 4. **Promote the Use of Cheques:** The commercial banks render an important service by providing to their customers a cheap medium of exchange like cheques. It is found much more convenient to settle debts through cheques rather than through the use of cash. The cheque is the most developed type of credit instrument in the money market.

5. **Financing Internal and Foreign Trade:** The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short-term loans to traders on the security of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.
6. **Remittance of Funds:** Commercial banks, on account of their network of branches throughout the country, also provide facilities to remit funds from one place to another for their customers by issuing bank drafts, mail transfers or telegraphic transfers on nominal commission charges. As compared to the postal money orders or other instruments, bank drafts have proved to be a much cheaper mode of transferring money and has helped the business community considerably.

B. Secondary Functions

Secondary banking functions of the commercial banks include:

1. Agency Services
2. General Utility Services

These are discussed below.

1. **Agency Services:** Banks also perform certain agency functions for and on behalf of their customers. The agency services are of immense value to the people at large. The various agency services rendered by banks are as follows:
 - (a) *Collection and Payment of Credit Instruments:* Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes etc., on behalf of their customers.
 - (b) *Purchase and Sale of Securities:* Banks purchase and sell various securities like shares, stocks, bonds, debentures on behalf of their customers.
 - (c) *Collection of Dividends on Shares:* Banks collect dividends and interest on shares and debentures of their customers and credit them to their accounts.
 - (d) *Acts as Correspondent:* Sometimes banks act as representative and correspondents of their customers. They get passports, traveller's tickets and even secure air and sea passages for their customers.
 - (e) *Income-tax Consultancy:* Banks may also employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.
 - (f) *Execution of Standing Orders:* Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premia etc., on behalf of their customers.
 - (g) *Acts as Trustee and Executor:* Banks preserve the 'Wills' of their customers and execute them after their death.
2. **General Utility Services:** In addition to agency services, the modern banks provide many general utility services for the community as given.

- (a) *Locker Facility*: Bank provide locker facility to their customers. The customers can keep their valuables, such as gold and silver ornaments, important documents; shares and debentures in these lockers for safe custody.
- (b) *Traveller's Cheques and Credit Cards*: Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.
- (c) *Letter of Credit*: Letters of credit are issued by the banks to their customers certifying their credit worthiness. Letters of credit are very useful in foreign trade.
- (d) *Collection of Statistics*: Banks collect statistics giving important information relating to trade, commerce, industries, money and banking. They also publish valuable journals and bulletins containing articles on economic and financial matters.
- (e) *Acting Referee*: Banks may act as referees with respect to the financial standing, business reputation and respectability of customers.
- (f) *Underwriting Securities*: Banks underwrite the shares and debentures issued by the Government, public or private companies.
- (g) *Gift Cheques*: Some banks issue cheques of various denominations to be used on auspicious occasions.
- (h) *Accepting Bills of Exchange on Behalf of Customers*: Sometimes, banks accept bills of exchange, internal as well as foreign, on behalf of their customers. It enables customers to import goods.
- (i) *Merchant Banking*: Some commercial banks have opened merchant banking divisions to provide merchant banking services.

C. Fulfillment of Socio-Economic Objectives

In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socio-economic objectives laid down by the state. For example, the nationalized banks in India have framed special innovative schemes of credit to help small agriculturists, village and cottage industries, retailers, artisans, the self employed persons through loans and advances at concessional rates of interest. Under the Differential Interest Scheme (D.I.S.) the nationalized banks in India advance loans to persons belonging to scheduled tribes, tailors, rickshaw-walas, shoe-makers at the concessional rate of 4 per cent per annum. This does not cover even the cost of the funds made available to these priority sectors. Banking is, thus, being used to subserve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

It is clear from the above that banks help development of trade and industry in the country. They encourage habits of thrift and saving. They help capital formation in the country. They lend money to traders and manufacturers. In the modern world, banks are to be considered not merely as dealers in money but also the leaders in economic development.

SOURCES OF BANK'S INCOME

A bank is a business organisation engaged in the business of borrowing and lending money. A bank can earn income only if it borrows at a lower rate and lends at a higher rate. The difference between the two rates will represent the costs incurred by the bank and the profit. Bank also provides a number of services to its customers for which it charges commission. This is also an important source of income. The followings are the various sources of a bank's profit:

1. **Interest on Loans:** The main function of a commercial bank is to borrow money for the purpose of lending at a higher rate of interest. Bank grants various types of loans to the industrialists and traders. The yields from loans constitute the major portion of the income of a bank. The banks grant loans generally for short periods. But now the banks also advance call loans which can be called at a very short notice. Such loans are granted to share brokers and other banks. These assets are highly liquid because they can be called at any time. Moreover, they are source of income to the bank.
2. **Interest on Investments:** Banks also invest an important portion of their resources in government and other first class industrial securities. The interest and dividend received from time to time on these investments is a source of income for the banks. Bank also earn some income when the market prices of these securities rise.
3. **Discounts:** Commercial banks invest a part of their funds in bills of exchange by discounting them. Banks discount both foreign and inland bills of exchange, or in other words, they purchase the bills at discount and receive the full amount at the date of maturity. For instance, if a bill of Rs. 1000 is discounted for Rs. 975, the bank earns a discount of Rs. 25 because bank pays Rs. 975 today, but will get Rs. 1000 on the due date. Discount, as a matter of fact, is the interest on the amount paid for the remaining period of the bill. The rate of discount on bills of exchange is slightly lower than the interest rate charged on loans and advances because bills are considered to be highly liquid assets.
4. **Commission, Brokerage, etc.:** Banks perform numerous services to their customers and charge commission, etc., for such services. Banks collect cheques, rents, dividends, etc., accepts bills of exchange, issue drafts and letters of credit and collect pensions and salaries on behalf of their customers. They pay insurance premiums, rents, taxes etc., on behalf of their customers. For all these services banks charge their commission. They also earn locker rents for providing safety vaults to their customers. Recently the banks have also started underwriting the shares and debentures issued by the joint stock companies for which they receive underwriting commission.

Commercial banks also deal in foreign exchange. They sell demand drafts, issue letters of credit and help remittance of funds in foreign countries. They also act as brokers in foreign exchange. Banks earn income out of these operations.

INVESTMENT POLICY OF BANKS

The financial position of a commercial bank is reflected in its balance sheet. The balance sheet is a statement of the assets and liabilities of the bank. The assets of the bank are distributed in accordance with certain guiding principles. These principles underline the investment policy of the bank. They are discussed below:

1. **Liquidity:** In the context of the balance sheet of a bank the term liquidity has two interpretations. First, it refers to the ability of the bank to honour the claims of the depositors. Second, it connotes the ability of the bank to convert its non-cash assets into cash easily and without loss.

It is a well known fact that a bank deals in funds belonging to the public. Hence, the bank should always be on its guard in handling these funds. The bank should always have enough cash to meet the demands of the depositors. In fact, the success of a bank depends to a considerable extent upon the degree of confidence it can instill in the minds of its depositors. If the depositors lose confidence in the integrity of their bank, the very existence of the bank will be at stake. So, the bank should always be prepared to meet the claims of the depositors by having enough cash. Among the various items on the assets side of the balance sheet, cash on hand represents the most liquid asset. Next comes cash with other banks and the central bank. The order of liquidity goes on descending.

Liquidity also means the ability of the bank to convert its non-cash assets into cash easily and without loss. The bank cannot have all its assets in the form of cash because each is an idle asset which does not fetch any return to the bank. So some of the assets of the bank, money at call and short notice, bills discounted, etc. could be made liquid easily and without loss.

2. **Profitability:** A commercial bank by definition, is a profit hunting institution. The bank has to earn profit to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and to meet the day-to-day expenditure. Since cash is the least profitable asset to the bank, there is no point in keeping all the assets in the form of cash on hand. The bank has got to earn income. Hence, some of the items on the assets side are profit yielding assets. They include money at call and short notice, bills discounted, investments, loans and advances, etc. Loans and advances, though the least liquid asset, constitute the most profitable asset to the bank. Much of the income of the bank accrues by way of interest charged on loans and advances. But, the bank has to be highly discreet while advancing loans.
3. **Safety or Security:** Apart from liquidity and profitability, the bank should look to the principle of safety of its funds also for its smooth working. While advancing loans, it is necessary that the bank should consider the three 'C' s of credit character, capacity and the collateral of the borrower. The bank cannot afford to invest its funds recklessly without considering the principle of safety. The loans and investments made by the bank should be adequately secured. For this purpose, the bank should

always insist on security of the borrower. Of late, somehow or other the banks have not been paying adequate importance to safety, particularly in India.

4. **Diversity:** The bank should invest its funds in such a way as to secure for itself an adequate and permanent return. And while investing its funds, the bank should not keep all its eggs in the same basket. Diversification of investment is necessary to avoid the dangerous consequences of investing in one or two channels. If the bank invest its funds in different types of securities or makes loans and advances to different objectives and enterprises, it shall ensure for itself a regular flow of income.
5. **Saleability of Securities:** Further, the bank should invest its funds in such types of securities as can be easily marketed at a time of emergency. The bank cannot afford to invest its funds in very long term securities or those securities which are unsaleable. It is necessary for the bank to invest its funds in government or in first class securities or in debentures of reputed firms. It should also advance loans against stocks which can be easily sold.
6. **Stability in the Value of Investments:** The bank should invest its funds in those stocks and securities the prices of which are more or less stable. The bank cannot afford to invest its funds in securities, the prices of which are subject to frequent fluctuations.
7. **Principles of Tax-Exemption of Investments:** Finally, the investment policy of a bank should be based on the principle of tax exemption of investments. The bank should invest in those government securities which are exempted from income and other taxes. This will help the bank to increase its profits.

Of late, there has been a controversy regarding the relative importance of the various principles influencing the investment policy of a bank particularly between liquidity and profitability. It is interesting to examine this controversy.

Let us examine what happens if the bank sticks to the principle of liquidity only. It is true that if the bank pays importance to liquidity, it can easily meet the demands of the depositors. The bank should have adequate cash to meet the claims of the depositors. It is true that a successful banking business calls for installing confidence in the minds of the depositors. But, it should be noted that accepting deposits is not the only function of a bank. Moreover, the bank cannot afford to forget the fact that it has to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and meet the day-to-day expenditure. If the bank keeps all its resources in liquid form, it will not be able to earn even a rupee. But profitability is a must for the bank. Though cash on hand is the most liquid asset, it is the least profitable asset as well. Cash is an idle asset. Hence, the banker cannot concentrate on liquidity only.

If the bank attaches importance to profitability only, it would be equally disastrous to the very survival of a bank. It is true that a bank needs income to meet its expenditure and pay returns to the depositors and shareholders. The bank cannot undermine the interests of the depositors. If the bank lends out all its funds,

it will be left with no cash at all to meet the claims of the depositors. It should be noted that the bank should have cash to honour the obligations of the depositors. Otherwise, there will be a 'run' on the bank. A run on the bank would be suicidal to the very existence of the bank. Loans and advances, though the most profitable asset, constitute the least liquid asset.

It follows from the above that the choice is between liquidity and profitability. The constant tug of war between liquidity and profitability is the feature of the assets side. According to Crowther, liquidity and profitability are opposing or conflicting considerations. The secret of successful banking lies in striking a balance between the two.

BALANCE SHEET OF THE BANK

The balance sheet of a commercial bank is a statement of its assets and liabilities. Assets are what others owe the bank, and what the bank owes others constitutes its liabilities. The business of a bank is reflected in its balance sheet and hence its financial position as well. The balance sheet is issued usually at the end of every financial year of the bank.

The balance sheet of the bank comprises of two sides; the assets side and the liabilities side. It is customary to record liabilities on the left side and assets on the right side. The following is the proforma of a balance sheet of the bank.

Balance Sheet of the Bank

Liabilities	Assets
1. Capital <ul style="list-style-type: none"> a. Authorised capital b. Issued capital c. Subscribed capital d. Paid-up-capital 	1. Cash <ul style="list-style-type: none"> a. Cash on hand b. Cash with central bank and other banks
2. Reserve fund	2. Money at call and short notice
3. Deposits	3. Bills discounted
4. Borrowings from other banks	4. Bills for collection
5. Bills payable	5. Investments
6. Acceptances and endorsements	6. Loans and advances
7. Contingent liabilities	7. Acceptances and endorsement
8. Profit and loss account	8. Fixed assets
9. Bills for collection	

Liabilities

Liabilities are those items on account of which the bank is liable to pay others. They denote other's claims on the bank. Now we have to analyse the various items on the liabilities side.

1. **Capital:** The bank has to raise capital before commencing its business. Authorised capital is the maximum capital upto which the bank is empowered to raise capital by the Memorandum of Association. Generally, the entire authorised capital is not raised from the public. That part of authorised capital which is issued in the form of shares for public subscription is called the issued capital. Subscribed capital represents that part of issued capital which is actually subscribed by the public. Finally, paid-up capital is that part of the subscribed capital which the subscribers are actually called upon to pay.
2. **Reserve Fund:** Reserve fund is the accumulated undistributed profits of the bank. The bank maintains reserve fund to tide over any crisis. But, it belongs to the shareholders and hence a liability on the bank. In India, the commercial bank is required by law to transfer 20 per cent of its annual profits to the Reserve fund.
3. **Deposits:** The deposits of the public like demand deposits, savings deposits and fixed deposits constitute an important item on the liabilities side of the balance sheet. The success of any banking business depends to a large extent upon the degree of confidence it can instill in the minds of the depositors. The bank can never afford to forget the claims of the depositors. Hence, the bank should always have enough cash to honour the obligations of the depositors.
4. **Borrowings from Other Banks:** Under this head, the bank shows those loans it has taken from other banks. The bank takes loans from other banks, especially the central bank, in certain extraordinary circumstances.
5. **Bills Payable:** These include the unpaid bank drafts and telegraphic transfers issued by the bank. These drafts and telegraphic transfers are paid to the holders thereof by the bank's branches, agents and correspondents who are reimbursed by the bank.
6. **Acceptances and Endorsements:** This item appears as a contra item on both the sides of the balance sheet. It represents the liability of the bank in respect of bills accepted or endorsed on behalf of its customers and also letters of credit issued and guarantees given on their behalf. For rendering this service, a commission is charged and the customers to whom this service is extended are liable to the bank for full payment of the bills. Hence, this item is shown on both sides of the balance sheet.
7. **Contingent Liabilities:** Contingent liabilities comprise of those liabilities which are not known in advance and are unforeseeable. Every bank makes some provision for contingent liabilities.
8. **Profit and Loss Account:** The profit earned by the bank in the course of the year is shown under this head. Since the profit is payable to the shareholders it represents a liability on the bank.
9. **Bills for Collection:** This item also appears on both the sides of the balance sheet. It consists of drafts and hundies drawn by sellers of goods on their customers and are sent to the bank for collection, against delivery documents like railway receipt, bill of lading, etc., attached thereto. All such bills in hand at the date of the balance sheet are shown on both the sides of the balance sheet because they form an asset of the

bank, since the bank will receive payment in due course, it is also a liability because the bank will have to account for them to its customers.

Assets

According to Crowther, the assets side of the balance sheet is more complicated and interesting. Assets are the claims of the bank on others. In the distribution of its assets, the bank is governed by certain well defined principles. These principles constitute the principles of the investment policy of the bank or the principles underlying the distribution of the assets of the bank. The most important guiding principles of the distribution of assets of the bank are liquidity, profitability and safety or security. In fact, the various items on the assets side are distributed according to the descending order of liquidity and the ascending order of profitability.

Now, we have to analyse the various items on the assets side.

1. **Cash:** Here we can distinguish cash on hand from cash with central bank and other banks cash on hand refers to cash in the vaults of the bank. It constitutes the most liquid asset which can be immediately used to meet the obligations of the depositors. Cash on hand is called the first line of defence to the bank.
In addition to cash on hand, the bank also keeps some money with the central bank or other commercial banks. This represents the second line of defence to the bank.
2. **Money at Call and Short Notice:** Money at call and short notice includes loans to the brokers in the stock market, dealers in the discount market and to other banks. These loans could be quickly converted into cash and without loss, as and when the bank requires. At the same time, this item yields income to the bank. The significance of money at call and short notice is that it is used by the banks to effect desirable adjustments in the balance sheet. This process is called 'Window Dressing'. This item constitutes the 'third line of defence' to the bank.
3. **Bills Discounted:** The commercial banks invest in short term bills consisting of bills of exchange and treasury bills which are self-liquidating in character. These short term bills are highly negotiable and they satisfy the twin objectives of liquidity and profitability. If a commercial bank requires additional funds, it can easily rediscount the bills in the bill market and it can also rediscount the bills with the central bank.
4. **Bills for Collection:** As mentioned earlier, this item appears on both sides of the balance sheet.
5. **Investments:** This item includes the total amount of the profit yielding assets of the bank. The bank invests a part of its funds in government and non-government securities.
6. **Loans and Advances:** Loans and advances constitute the most profitable asset to the bank. The very survival of the bank depends upon the extent of income it can earn by advancing loans. But, this item is the least liquid asset as well. The bank earns quite a sizeable interest from the loans and advances it gives to the private individuals and commercial firms.

7. **Acceptances and Endorsements:** As discussed earlier, this item appears as a contra item on both sides of the balance sheet.
8. **Fixed Assets:** Fixed assets include building, furniture and other property owned by the bank. This item includes the total volume of the movable and immovable property of the bank. Fixed assets are referred to as 'dead stocks'. The bank generally undervalues this item deliberately in the balance sheet. The intention here is to build up secret reserves which can be used at times of crisis.

Balance sheet of a bank acts as a mirror of its policies, operations and achievements. The liabilities indicate the sources of its funds; the assets are the various kinds of debts incurred by a bank to its customers. Thus, the balance sheet is a complete picture of the size and nature of operations of a bank.

CREDIT CREATION

An important function performed by the commercial banks is the creation of credit. The process of banking must be considered in terms of monetary flows, that is, continuous depositing and withdrawal of cash from the bank. It is only this activity which has enabled the bank to manufacture money. Therefore the banks are not only the purveyors of money but manufacturers of money.

Basis of Credit Creation

The basis of credit money is the bank deposits. The bank deposits are of two kinds viz., (1) Primary deposits, and (2) Derivative deposits.

1. **Primary Deposits:** Primary deposits arise or formed when cash or cheque is deposited by customers. When a person deposits money or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants by cheques. These deposits are called "primary deposits" or "cash deposits." It is out of these primary deposits that the bank makes loans and advances to its customers. The initiative is taken by the customers themselves. In this case, the role of the bank is passive. So these deposits are also called "passive deposits." These deposits merely convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.
2. **Derivative Deposits:** Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called "derivative deposits." Since the bank play an active role in the creation of such deposits, they are also known as "active deposits." When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. The bank does not pay him cash. The customer is free to withdraw the amount whenever he wants by cheques. Thus the banker lends money in the form

of deposit credit. The creation of a derivative deposit does result in a net increase in the total supply of money in the economy, Hartly Withers says “every loan creates a deposit.” It may also be said “loans make deposits” or “loans create deposits.” It is rightly said that “deposits are the children of loans, and credit is the creation of bank clerk’s pen.”

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank discounts a bill or purchase government securities. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus asset acquired by a bank creates an equivalent bank deposit. It is perfectly correct to state that “bank loans create deposits.” The derivate deposits are regarded as bank money or credit. Thus the power of commercial banks to expand deposits through loans, advances and investments is known as “credit creation.”

Thus, credit creation implies multiplication of bank deposits. Credit creation may be defined as “the expansion of bank deposits through the process of more loans and advances and investments.”

Process of Credit Creation

An important aspect of the credit creating function of the commercial banks is the process of multiple-expansion of credit. The banking system as a whole can create credit which is several times more than the original increase in the deposits of a bank. This process is called the multiple-expansion or multiple-creation of credit. Similarly, if there is withdrawal from any one bank, it leads to the process of multiple-contraction of credit. The process of multiple credit-expansion can be illustrated by assuming

- (a) The existence of a number of banks, A, B, C etc., each with different sets of depositors.
- (b) Every bank has to keep 10% of cash reserves, according to law, and,
- (c) A new deposit of Rs. 1,000 has been made with bank A to start with.

Suppose, a person deposits Rs. 1,000 cash in Bank A. As a result, the deposits of bank A increase by Rs. 1,000 and cash also increases by Rs. 1,000. The balance sheet of the bank is as follows:

Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
New deposit	1,000	New Cash	1,000
Total	1,000		1,000

Under the double entry system, the amount of Rs. 1,000 is shown on both sides. The deposit of Rs. 1,000 is a liability for the bank and it is also an asset to the bank. Bank A has to keep only 10% cash reserve, i.e., Rs. 100 against its new deposit and it has a surplus of Rs. 900 which it can profitably employ in the assets like loans. Suppose bank A gives a loan to X, who uses the amount to pay off his creditors. After the loan has been made and the amount so withdrawn by X to pay off his creditors, the balance sheet of bank A will be as follows:

Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
Deposit	1,000	New Cash	100
		Loan to X	900
Total	1,000		1,000

Suppose X purchase goods of the value of Rs. 900 from Y and pay cash. Y deposits the amount with Bank B. The deposits of Bank B now increase by Rs. 900 and its cash also increases by Rs. 900. After keeping a cash reserve of Rs. 90, Bank B is free to lend the balance of Rs. 810 to any one. Suppose bank B lends Rs. 810 to Z, who uses the amount to pay off his creditors. The balance sheet of bank B will be as follows:

Balance Sheet of Bank B

Liabilities	Rs.	Assets	Rs.
Deposit	900	Cash	90
		Loan to Z	810
Total	900		900

Suppose Z purchases goods of the value of Rs. 810 from S and pays the amount. S deposits the amount of Rs. 810 in bank C. Bank C now keeps 10% as reserve (Rs. 81) and lends Rs. 729 to a merchant. The balance sheet of bank C will be as follows:

Balance Sheet of Bank C

Liabilities	Rs.	Assets	Rs.
Deposit	810	Cash	81
		Loan	729
Total	810		810

Thus looking at the banking system as a whole, the position will be as follow:

Name of bank	Deposits Rs.	Cash reserve Rs.	Loan Rs.
Bank A	1,000	100	900
Bank B	900	90	810
Bank C	810	81	729
Total	2,710	271	2,439

It is clear from the above that out of the initial primary deposit, bank advanced Rs. 900 as a loan. It formed the primary deposit of bank B, which in turn advanced Rs. 810 as loan. This sum again formed, the primary deposit of bank C, which in turn advanced Rs. 729 as loan. Thus the initial primary deposit of Rs. 1,000 resulted in bank credit of Rs. 2439 in three banks. There will be many banks in the country and the above process of credit expansion will come to an end when no bank has an excess reserve to lend. In the above example, there will be 10 fold increase in credit because the cash ratio is 10%. The total volume of credit created in the banking system depends on the cash ratio. If the cash ratio is 10% there will be 10 fold increase. If it is 20%, there will be 5 fold increase. When the banking system receives an additional primary deposit, there will be multiple expansion of credit. When the banking system loses cash, there will be multiple contraction of credit.

The extent to which the banks can create credit together could be found out with the help of the credit multiplier formula. The formula is:

$$K = \frac{1}{r}$$

Where K is the credit multiplier, and r, the required reserves. If the reserve ratio is 10% the size of credit multiplier will be:

$$K = \frac{1}{r} = \frac{1}{0.1} = 10$$

It means that the banking system can create credit together which is ten times more than the original increase in the deposits. It should be noted here that the size of credit multiplier is inversely related to the percentage of cash reserves the banks have to maintain. If the reserve ratio increases, the size of credit multiplier is reduced and if the reserve ratio is reduced, the size of credit multiplier will increase.

Leaf and Cannon Criticism

Walter Leaf and Edwin Cannon objected to the theory of credit creation. According to them, the commercial bank cannot lend anything more than what it receives as cash from deposits. But the contention of Leaf and Cannon that banks cannot create credit is wrong due to the following reasons:

- (a) A single bank may not be able to create derivative deposits in excess of its cash reserves. But the banking system as a whole can do what a single bank cannot do.
- (b) As Crowther points out that the total net deposits of commercial banks are for in excess of their cash reserves. It means they can create credit.

Limitation on Credit Creation

The commercial banks do not have unlimited power of credit creation. Their power to create credit is limited by the following factors:

1. **Amount of Cash:** The power to create credit depends on the cash received by banks. If banks receive more cash, they can create more credit. If they receive less cash they can create less credit. Cash supply is controlled by the central bank of the country.
2. **Cash Reserve Ratio:** All deposits cannot be used for credit creation. Banks must keep certain percentage of deposits in cash as reserve. The volume of bank credit depends also on the cash reserve ratio the banks have to keep. If the cash reserve ratio is increased, the volume of credit that the banks can create will fall. If the cash reserve ratio is lowered, the bank credit will increase. The Central Bank has the power to prescribe and change the cash reserve ratio to be kept by the commercial banks. Thus the central bank can change the volume of credit by changing the cash reserve ratio.
3. **Banking Habits of the People:** The loan advanced to a customer should again come back into banks as primary deposit. Then only there can be multiple expansion. This will happen only when the banking habit among the people is well developed. They should keep their money in the banks as deposits and use cheques for the settlement of transactions.
4. **Nature of Business Conditions in the Economy:** Credit creation will depend upon the nature of business conditions. Credit creation will be large during a period of prosperity, while it will be smaller during a depression. During periods of prosperity, there will be more demand for loans and advances for investment purposes. Many people approach banks for loans and advances. Hence, the volume of bank credit will be high. During periods of business depression, the amount of loans and advances will be small because businessmen and industrialists may not come to borrow. Hence the volume of bank credit will be low.
5. **Leakages in Credit-Creation:** There may be some leakages in the process of credit creation. The funds may not flow smoothly from one bank to another. Some people may keep a portion of their amount as idle cash.
6. **Sound Securities:** A bank creates credit in the process of acquiring sound and profitable assets, like bills, and government securities. If people cannot offer sound securities, a bank cannot create credit. Crowther says “a bank cannot create money out of thin air. It transmutes other forms of wealth into money.”
7. **Liquidity Preference:** If people desire to hold more cash, the power of banks to create credit is reduced.
8. **Monetary Policy of the Central Bank:** The extent of credit creation will largely depend upon the monetary policy of the Central Bank of the country. The Central Bank has the power to influence the volume of money in circulation and through this it can influence the volume of credit created by the banks. The Central Bank has also certain powerful weapons, like the bank rate, open market operations with the help of which it can exercise control on the expansion and contraction of credit by the commercial bank.

Thus, the ability of the bank to create credit is subject to various limitations. Still, one should not undermine the importance of the function of credit creation of the banks. This function has far-reaching effect on the working of the economy, especially on the business activity. Bank credit is the oil which lubricates the wheels of the business machine.

UNIT BANKING VS BRANCH BANKING

The banking system in different countries vary substantially from one another. Broadly speaking, however, there are two important types of banking systems, viz., unit banking and branch banking.

A. Unit Banking

'Unit banking' means a system of banking under which banking services are provided by a single banking organisation. Such a bank has a single office or place of work. It has its own governing body or board of directors. It functions independently and is not controlled by any other individual, firm or body corporate. It also does not control any other bank. Such banks can become member of the clearing house and also of the Banker's Association. Unit banking system originated and grew in the U.S.A. Different unit banks in the U.S.A. are linked with each other and with other financial centres in the country through "correspondent banks."

Advantages of Unit Banking

Following are the main advantages of unit banking:

1. **Efficient Management:** One of the most important advantages of unit banking system is that it can be managed efficiently because of its size and work. Co-ordination and control becomes effective. There is no communication gap between the persons making decisions and those executing such decisions.
2. **Better Service:** Unit banks can render efficient service to their customers. Their area of operation being limited, they can concentrate well on that limited area and provide best possible service. Moreover, they can take care of all banking requirements of a particular area.
3. **Close Customer-banker Relations:** Since the area of operation is limited the customers can have direct contact. Their grievances can be redressed then and there.
4. **No Evil Effects Due to Strikes or Closure:** In case there is a strike or closure of a unit, it does not have much impact on the trade and industry because of its small size. It does not affect the entire banking system.
5. **No Monopolistic Practices:** Since the size of the bank and area of its operation are limited, it is difficult for the bank to adopt monopolistic practices. Moreover, there is free competition. It will not be possible for the bank to indulge in monopolistic practices.

6. **No Risks of Fraud:** Due to small size of the bank, there is stricter and closer control of management. Therefore, the employees will not be able to commit fraud.
7. **Closure of Inefficient Banks:** Inefficient banks will be automatically closed as they would not be able to satisfy their customers by providing efficient service.
8. **Local Development:** Unit banking is localised banking. The unit bank has the specialised knowledge of the local problems and serves the requirement of the local people in a better manner than branch banking. The funds of the locality are utilised for the local development and are not transferred to other areas.
9. **Promotes Regional Balance:** Under unit banking system, there is no transfer of resources from rural and backward areas to the big industrial and commercial centres. This tends to reduce regional imbalance.

Disadvantages of Unit Banking

1. **No Economies of Large Scale:** Since the size of a unit bank is small, it cannot reap the advantages of large scale viz., division of labour and specialisation.
2. **Lack of Uniformity in Interest Rates:** In unit banking system there will be large number of banks in operation. There will be lack of control and therefore their rates of interest would differ widely from place to place. Moreover, transfer of funds will be difficult and costly.
3. **Lack of Control:** Since the number of unit banks is very large, their co-ordination and control would become very difficult.
4. **Risks of Bank's Failure:** Unit banks are more exposed to closure risks. Bigger unit can compensate their losses at some branches against profits at the others. This is not possible in case of smaller banks. Hence, they have to face closure sooner or later.
5. **Limited Resources:** Under unit banking system the size of bank is small. Consequently its resources are also limited. Hence, they cannot meet the requirements of large scale industries.
6. **Unhealthy Competition:** A number of unit banks come into existence at an important business centre. In order to attract customers they indulge in unhealthy competition.
7. **Wastage of National Resources:** Unit banks concentrate in big metropolitan cities whereas they do not have their places of work in rural areas. Consequently there is uneven and unbalanced growth of banking facilities.
8. **No Banking Development in Backward Areas:** Unit banks, because of their limited resources, cannot afford to open uneconomic branches in smaller towns and rural areas. As such, these areas remain unbanked.
9. **Local Pressure:** Since unit banks are highly localised in their business, local pressures and interferences generally disrupt their normal functioning.

B. Branch Banking System

It means a system of banking in which a banking organisation works at more than one place. The main place of business is called head office and the other places of business are called branches. The head office controls and co-ordinates the work at branches. The day-to-day operations are performed by the branch manager as per the policies and directions issued from time to time by the head office.

This system of banking is prevalent throughout the world. In India also, all the major banks have been operating under branch banking system.

Advantages of Branch Banking

1. **Better Banking Services:** Such banks, because of their large size can enjoy the economies of large scale viz., division of work and specialisation. These banks can also afford to have the specialised services of bank personnel which the unit banks can hardly afford.
2. **Extensive Service:** Branch banking can provide extensive service to cover large area. They can open their branches throughout the country and even in foreign countries.
3. **Decentralisation of Risks:** In branch banking system branches are not concentrated at one place or in one industry. These are decentralised at different places and in different industries. Hence the risks are also distributed.
4. **Uniform Rates of Interest:** In branch banking, there is better control and co-ordination of the central bank. Consequently interest rates can be uniform.
5. **Better Cash Management:** In branch banking there can be better cash management as cash easily be transferred from one branch to another. Therefore, there will be lesser need to keep the cash idle for meeting contingencies.
6. **Better Training Facilities to Employees:** Under branch banking the size of the bank is quite large. Therefore, such banks can afford to provide better training facilities to their employees. Almost every nationalised bank in India has its separate training college.
7. **Easy and Economical Transfer of Funds:** Under branch banking, a bank has a widespread of branches. Therefore, it is easier and economical to transfer funds from one branch to the other.
8. **Better Investment of Funds:** Such bank can afford the services of specialised and expert staff. Therefore they invest their funds in such industries where they get the highest return and appreciation without sacrificing the safety and liquidity of funds.
9. **Effective Central Bank Control:** Under branch banking, the central bank has to deal only with a few big banks controlling a large number of branches. It is always easier and more convenient to the central bank to regulate and control the credit policies of a few big banks, than to regulate and control the activities of a large number of small unit banks. This ensures better implementation of monetary policy.

10. **Contacts with the Whole Country:** Under branch banking, the bank maintains continual contacts with all parts of the country. This helps it to acquire correct and reliable knowledge about economic conditions in various parts of the country. This knowledge enables the bank to make a proper and profitable investment of its surplus funds.
11. **Greater Public Confidence:** A bank, with huge financial resources and number of branches spread throughout the country, can command greater public confidence than a small unit bank with limited resources and one or a few branches.

Disadvantages of Branch Banking

Following are the disadvantages of branch banking:

1. **Difficulties of Management, Supervision and Control:** Since there are hundreds of branches of a bank under this system, management, supervision and control became more inconvenient and difficult. There are possibilities of mismanagement in branches. Branch managers may misuse their position and misappropriate funds. There is great scope for fraud. Thus there are possibilities of fraud and irregularities in the financial management of the bank.
2. **Lack of Initiative:** The branches of the bank under this system suffer from a complete lack of initiative on important banking problems confronting them. No branch of the bank can take decision on important problems without consulting the head office. Consequently, the branches of the bank find themselves unable to carry on banking activities in accordance with the requirements of the local situation. This makes the banking system rigid and inelastic in its functioning. This also leads to “red-tapism” which means “official delay.”
3. **Monopolistic Tendencies:** Branch banking encourages monopolistic tendencies in the banking system. A few big banks dominate and control the whole banking system of the country through their branches. This can lead to the concentration of resources in the hands of a small number of men. Such a monopoly power is a source of danger to the community, whose goal is a socialistic pattern of society.
4. **Regional Imbalances:** Under the branch banking system, the financial resources collected in the smaller and backward regions are transferred to the bigger industrial centres. This encourages regional imbalances in the country.
5. **Continuance of Non-profitable Branches:** Under branch banking, the weak and unprofitable branches continue to operate under the protection cover of the stronger and profitable branches.
6. **Unnecessary Competition:** Branch banking is delocalised banking, under branch banking system, the branches of different banks get concentrated at certain places, particularly in big towns and cities. This gives rise to unnecessary and unhealthy competition among them. The branches of the competing banks try to tempt customers by offering extra inducements and facilities to them. This naturally increases the banking expenditure.

7. **Expensiveness:** Branch banking system is much more expensive than the unit banking system. When a bank opens a number of branches at different places, then there arises the problem of co-ordinating their activities with others. This necessitates the employment of expensive staff by the bank.
8. **Losses by Some Branches Affect Others:** When some branches suffer losses due to certain reasons, this has its repercussions on other branches of the bank.

Thus branch banking system as well as unit banking system suffer from defects and drawbacks. But the branch banking system is, on the whole, better than the unit banking system. In fact, the branch banking system has proved more suitable for backward and developing countries like India. Branch banking is very popular and successful in India. A comparison between unit banking and branch banking is essentially a comparison between small-scale and large-scale operations.

COMMERCIAL BANKS AND ECONOMIC DEVELOPMENT

Commercial banks are considered not merely as dealers in money but also the leaders in economic development. They are not only the store houses of the country's wealth but also the reservoirs of resources necessary for economic development. They play an important role in the economic development of a country. A well-developed banking system is essential for the economic development of a country. The "Industrial Revolution" in Europe in the 19th century would not have been possible without a sound system of commercial banking. In case of developing countries like India, the commercial banks are considered to be the backbone of the economy. Commercial banks can contribute to a country's economic development in the following ways :

1. **Accelerating the Rate of Capital Formation:** Capital formation is the most important determinant of economic development. The basic problem of a developing economy is slow rate of capital formation. Banks promote capital formation. They encourage the habit of saving among people. They mobilise idle resources for production purposes. Economic development depends upon the diversion of economic resources from consumption to capital formation. Banks help in this direction by encouraging saving and mobilising them for productive uses.
2. **Provision of Finance and Credit:** Commercial banks are a very important source of finance and credit for industry and trade. Credit is a pillar of development. Credit lubricates all commerce and trade. Banks become the nerve centre of all commerce and trade. Banks are instruments for developing internal as well as external trade.
3. **Monetisation of Economy:** An underdeveloped economy is characterised by the existence of a large non-monetised sector. The existence of this non-monetised sector is a hindrance in the economic development of the country. The banks, by opening branches in rural and backward areas can promote the process of monetisation (conversion of debt into money) in the economy.

4. **Innovations:** Innovations are an essential prerequisite for economic development. These innovations are mostly financed by bank credit in the developed countries. But in underdeveloped countries, entrepreneurs hesitate to invest in new ventures and undertake innovations largely due to lack of funds. Facilities of bank loans enable the entrepreneurs to step up their investment on innovational activities, adopt new methods of production and increase productive capacity of the economy.
5. **Implementation of Monetary Policy:** Economic development need an appropriate monetary policy. But a well-developed banking is a necessary pre-condition for the effective implementation of the monetary policy. Control and regulation of credit by the monetary authority is not possible without the active co-operation of the banking system in the country.
6. **Encouragement to Right Type of Industries:** Banks generally provide financial resources to the right type of industries to secure the necessary material, machines and other inputs. In this way they influence the nature and volume of industrial production.
7. **Development of Agriculture:** Underdeveloped economies are primarily agricultural economies. Majority of the population in these economies live in rural areas. Therefore, economic development in these economies requires the development of agriculture and small scale industries in rural areas. So far banks in underdeveloped countries have been paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must provide loans to agriculture for development and modernisation of agriculture. In recent years, the State Bank of India and other commercial banks are granting short term, medium-term and long-term loans to agriculture and small-scale industries.
8. **Regional Development:** Banks can also play an important role in achieving balanced development in different regions of the country. They transfer surplus capital from the developed regions to the less developed regions, where it is scarce and most needed. This reallocation of funds between regions will promote economic development in underdeveloped areas of the country.
9. **Promote Industrial Development:** Industrial development needs finance. In some countries, commercial banks encouraged industrial development by granting long-term loans also. Loan or credit is a pillar to development. In underdeveloped countries like India, commercial banks are granting short-term and medium-term loans to industries. They are also underwriting the issue of shares and debentures by industrial concerns. This helps industrial concerns to secure adequate capital for their establishment, expansion and modernisation. Commercial banks are also helping manufacturers to secure machinery and equipment from foreign countries under instalment system by guaranteeing deferred payments. Thus, banks promote or encourage industrial development.

10. **Promote Commercial Virtues:** The businessmen are more afraid of a banker than a preacher. The businessmen should have certain business qualities like industry, forethought, honesty and punctuality. These qualities are called “commercial virtues” which are essential for rapid economic progress. The banker is in a better position to promote commercial virtues. Banks are called “public conservators of commercial virtues.”
11. **Fulfillment of Socio-economic Objectives:** In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socio-economic objectives laid down by the state. For example, nationalised bank in India have framed special innovative schemes of credit to help small agriculturists, self-employed persons and retailers through loans and advances at concessional rates of interest. Banking is thus used to achieve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

Thus, banks in a developing country have to play a dynamic role. Economic development places heavy demand on the resources and ingenuity of the banking system. It has to respond to the multifarious economic needs of a developing country. Traditional views and methods may have to be discarded. “An Institution, such as the banking system, which touches and should touch the lives of millions, has necessarily to be inspired by a larger social purpose and has to subserve national priorities and objectives.” A well-developed banking system provides a firm and durable foundation for the economic development of the country.

Conclusion

From the above discussion, undoubtedly, we can say that, commercial banks form the most important part of financial intermediaries. It accepts deposits from the general public and extends loans to the households, firms and the government. Banks form a significant part of the infrastructure essential for breaking vicious circle of poverty and promoting economic growth.

Questions for Discussion

1. What is a commercial bank? What are the main functions performed by commercial banks? How far are they useful for economic development?
2. State the kinds of commercial banks.
3. What do you understand by a commercial bank’s balance sheet? What specific information does it convey?
4. What is the investment policy of a commercial bank? Explain the factors that constitute for formulating a suitable investment policy.
5. What is credit creation? How banks create credit? What are the limitations of credit creation?
6. State the advantages and disadvantages of unit banking system.
7. State the advantages and disadvantages of branch banking system.
8. Discuss the role of banks in a developing economy.